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21 May 1976

DCI BRIEFING FOR
JOINT ECONOMIC COMMITTEE
24 May 1976

INTRODUCTION

- I. Mr. Chairman, it is a pleasure to be here this morning. I am glad to be following precedent of discussing with the subcommittee the economies of the Soviet Union and the People's Republic of China.
- A. I am also pleased to note that in the eleven months since Mr. Colby last appeared here, CIA analysts have continued to contribute substantially to the highly useful products sponsored by this committee. I understand that this practice began some 15 years ago, when the Agency first contributed to the Committee's annual compendium of papers on the Soviet and Chinese economies. I welcome this opportunity to make the results of our analytical efforts available on an unclassified basis, to scholars and government components outside the intelligence community.

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1. In that connection, I have been pleased to learn that the Agency has followed the practice of providing your committee with each unclassified study concerning the Soviet and Chinese economies as they are completed, and that members of your staff have received occasional briefing on these subjects.
 - B. At this point, Mr. Chairman, I would like to make a few general observations on the two major economies and their allocation of resources, and then speak on the special matter of the refiguring of Soviet defense spending on the basis of rubles.
- II. First, let me highlight a few features of current Soviet economic trends.
- A. In 1975 the Soviet economy suffered its most serious setback since Brezhnev came to power. For agriculture, the year was disastrous. And in trade, the combination of increased grain imports and sluggish Western demand for Soviet exports led to a record hard currency trade deficit.

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- B. Last year's troubles will hurt the economy's performance this year.
1. We are getting reports of food shortages, particularly of meat, as well as stories of work slow-downs and vandalism in the markets, as the people vent their ire.
 2. People are grumbling, but this is not likely to pose problems of public order that the regime cannot cope with.
- C. In planning for 1976, the Soviets have had to cut back their targets to allow for inevitable shortages of farm products. Apparently some prospective contracts for Western technology and equipment have also been shelved, possibly because of the hard-currency bind.
1. The 1976 plan embodies relatively moderate goals, which we consider to be generally attainable.
- D. Similarly, the basic guidelines of the Soviets' 10th Five-Year Plan, which begins this year, are generally much like those of the last one, though they set more modest goals. They reflect the restrained approach of Brezhnev's leadership over the

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past 10 years. He has taken no steps to make bold, innovative changes in the economic system.

E. As you will hear soon, Mr. Chairman, we see many signs that the Soviet economy has entered a period of slower growth, at a time when all major sectors -- defense, industrial growth, and consumption -- are demanding increases. I would only underline that the leadership's handling of these issues is bound to be contentious, particularly when the old guard of the politburo will be passing from the scene.

III. In respect to China, Mr. Chairman, the picture is one of more impressive growth, but in a highly erratic overall pattern.

A. As in the Soviet Union, agriculture has generally been a problem area. The Chinese have been according an increasing share of resources to agriculture. They also are having some success in stemming the growth of the population, now estimated to be about 950 million.

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B. Second, I would remind you that the greatest disruptions in China's economic growth have closely matched periods of political turbulence -- the Great Leap Forward in the early 1960s, the Cultural Revolution of the late 60s, and the anti-Confucius campaign of two years ago. So in trying to project economic trends into the future, we must provide a cautionary note in view of the sudden leadership changes in Peking this year.

1. Chou's death, the subsequent removal of Teng Hsiao-ping as acting premier, and the elevation of Hua Kuo-feng to the premiership last month took place in a period of political controversy that underlines the uncertainty surrounding future policies. Attacks on Teng Hsiao-ping have raised specific economic issues.

C. Nevertheless, Chinese awareness of the close connection between success in economic development and political stability perhaps explains why -- during the struggle to oust Teng Hsiao-ping -- careful attention was given to emphasizing that nothing

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should interfere with production or other operations in the economy.

1. The situation is obviously still fluid. Chou's death and Chairman Mao's physical decline have ushered in a period of political turbulence which may become intensified upon Mao's death. Past experience suggests that such turmoil might cause marked disturbances in the economy as well.

- IV. My final comments, Mr. Chairman, concern your committee's special interest in Moscow's allocation of resources to military and space functions, especially as figured in the Soviets' own budgets, that is, in rubles.



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B. Applying our building block methodology to this new information, we have of course changed our estimates. Some of these changes seem quite startling, at first glance at least.

1. For my part, Mr. Chairman, I just want to say how impressed I am with the intelligence community's constant re-examining of old judgments in the light of the unceasing flow of new information.

C. Also, I must add my own words of caution on the dangers of magnifying the significance of any of these figures in themselves, whether in dollars or in rubles. At most, they offer some elucidation of trends, relative internal priorities, and general order of magnitude.

D. It is also important not to misunderstand the significance of the new estimate of the share of Soviet GNP devoted to defense, as expressed in rubles. It does not signify a dramatic jump in the size of Soviet defense

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programs. It does reflect an increase in our assessment of the cost of those programs.

- V. Mr. Chairman, we appreciate testifying in closed session so that we may answer your questions without the inhibiting effects of concern for protection of sources and methods. We will later review the transcript to remove any classified information with the aim of permitting the publication of as much of our testimony as possible.

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PART I: THE SOVIET ECONOMY

Results in 1975

I. Mr. Chairman, I would like to expand on the Soviet economic situation in 1975-76 and on likely developments during the remainder of the decade.

A. Last year the growth of Soviet gross national product slumped to about 2 1/2 percent compared with the 4 percent annual average rate in 1971-74.

(Chart: US-USSR: GNP)

1. The miserable grain harvest -- output was only 140 million tons compared with a plan of 216 million tons -- pulled total agricultural output down by 9 percent.

Since agriculture represents roughly one-fifth of GNP, this drop clearly was the major factor in last year's decline in the rate of overall growth.

2. Moscow took a number of steps to lower the demand for grain:

a. Livestock was fed substitutes such as reeds and leaves, and in some cases actually moved out of the drought-afflicted areas;

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- b. All grain export commitments to Eastern Europe were canceled. These had been running at about 7 million tons annually.
- 3. At the same time, grain reserve stocks were drawn on heavily -- to what we believe are now minimal levels -- and Moscow arranged large-scale grain imports.
 - a. Including the most recent deals with Canada, Australia, and the US, we calculate the Soviets have purchased about 37 million tons since July, including 19 million tons from us.
- 4. Despite all these measures, feed supplies in the USSR have been inadequate. Distress slaughtering began as early as last summer, and by yearend, inventories of hogs and poultry -- the two principal grain consumers -- were down by 20 percent and 15 percent respectively.
 - a. This meant a short-term rise in meat, but at the expense of future supplies. Both the quantity and quality of meat evidently have already turned down.

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We estimate that the Soviet consumer will get 25 percent less meat this year than last.

B. Soviet industrial output was about normal in 1975. It grew by 6 1/2 percent, in line with average over the past five years. (*Chart: US-USSR: Industrial Growth*)

1. The production of industrial raw materials grew impressively, chemicals being the star performer.
2. The output of consumer goods grew less than in the past.
3. Producer durables also fell off.
4. And the production of primary energy continued to move up steadily, reflecting the USSR's unique position of energy self-sufficiency among the world's industrialized powers. (*Charts: US-USSR: Primary Energy, 1975; USSR: Oil and Natural Gas Production and Trade*) Even though the Soviets face difficult problems in developing petroleum fields in distant and inhospitable areas, it is

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only a question of time before these extensive reserves come on stream.

5. Steel output was at a record level, but demand still outran domestic supply, so imports continued to be high. (*Chart: Crude Steel Production in Major Countries*)

6. As for machinery, technologically advanced items, and equipment for the agricultural sector led the way.

a. Dramatic rates of increase -- such as 32 percent for computer equipment -- were possible because output in 1974 was low compared with levels in other industrialized countries.

The USSR is now concentrating on a computer series modelled on the technology of the IBM 360 line, which was developed here in the early 1960s.

C. In the area of capital investment, the Soviets last year continued to devote a high proportion of GNP -- one-fourth compared to about one-sixth in the US -- to expanding the stock of new plant and equipment.

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D. All in all, the Soviet consumer had a relatively good year in 1975, despite the worsening agricultural situation. The food marketing pipeline remained full, aided by distress slaughtering, and other consumer goods and services were more available than before.

(Charts: US-USSR: *Composition of Diets*, 1974; US-USSR: *Per Capita Consumption*, 1974)

1. On a less positive note, the increase in average wages was kept down again last year to restrain inflationary pressures; savings bank deposits rose again until they are now equivalent to more than one-third of total money incomes.
2. The total supply of new housing edged up, but living space -- on a per capita basis -- remains below even Soviet norms.

E. Soviet foreign trade continued to rise last year. Its value, measured in dollars, grew by an impressive 35 percent; on a volume basis we estimate the rise to be well under half of this rate of increase.

1. The rapid rise in imports from the developed West (including Japan) plus a

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drop in demand in the West has resulted in hard-currency deficits in recent years.

(Chart: USSR: Hard-Currency Merchandise Trade) Last year, with recession in the West cutting demand still further, the foreign-exchange position deteriorated dramatically. The USSR had a roughly \$5 billion hard currency trade deficit compared with a \$900 million deficit in 1974.

- a. This occurred despite a further rise in the share of high-priced oil and oil products in Soviet exports. (Chart: USSR: Oil Share of Hard Currency Exports)
- b. The Soviets finance their large and escalating hard-currency trade deficits through a combination of credits and gold sales. With the conspicuous exception of the US, since mid-1974 Western governments have extended or backed more than \$11 billion in long-term credits to finance Soviet purchases of machinery and equipment.

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- c. Although the USSR's medium and long-term debt rose rapidly last year to at least \$7 billion, debt service remains manageable, as it accounted for only about one fifth of Moscow's hard-currency earnings in 1975.
- d. While the Soviets are concerned, they still purchased last year more than \$4 billion in Western technology and equipment for future delivery.

Soviet Economic Aid to LDCs

- F. You are interested, Mr. Chairman, in how the Soviet economic aid program fared in these circumstances. Deliveries to LDCs last year were about \$400 million, the 1970-73 average, down by one third from the unusually high 1974 figure swollen by emergency wheat shipments to India.
- 1. As before, the Near East and South Asia received the lion's share. Egypt, Iran, India, Turkey, and Iraq alone accounted for more than 70 percent of total aid deliveries.

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2. New commitments were up sharply, to a record \$1.3 billion. They included Moscow's largest credits ever extended to LDCs -- \$437 million to Afghanistan and \$650 million to Turkey.
3. We expect the Soviets to maintain recent delivery levels in 1976 despite the possibility that Egypt will begin to phase out the Soviet program. Expanded deliveries to other Near East and South Asian countries should make up the shortfall.

The Outlook for 1976

- II. Turning now to the Soviet economic plan for 1976, one is immediately struck by the generally low and fairly realistic goals projected -- with the possible exception of agriculture. Clearly the Kremlin recognizes that last year's harvest failure will have substantial carryover effects. (*Chart: USSR: Growth of GNP, by Sector of Origin*)
 - A. The consumer will be hardest hit; growth of industrial production also will be slowed, and the Soviets will continue to

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carry a sizable hard-currency trade deficit. GNP as a whole is planned to increase by about 4 1/2 percent (up from the estimated 1975 rate of 2 1/2 percent).

B. The projected increase in industrial output of 4 1/2 percent is the lowest planned for since World War II.

1. This low target reflects anticipated shortages of agricultural raw materials and continuing lags in bringing new plant and equipment on stream.
2. Targets for both heavy and light industry are down by historical standards, but heavy industry retains preference, as usual.

C. Growth in total investment is to be halved, to about 4 percent.

1. Once again the plan places major emphasis on completing unfinished investment projects and modernizing existing plant and equipment.
2. Agriculture and its supporting industries are to maintain their priority

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status, receiving more than one third of total investment.

- D. Among the many ingredients in the plans, the most questionable is agriculture, which is scheduled to rebound, from a 9 percent decline in 1975 to a 9 percent growth this year. With grain stocks down and livestock herds reduced, the agricultural situation seems bound to remain precarious.
1. Achievement of the ambitious agricultural output goal is crucially dependent on above-average weather during the rest of the growing and harvesting seasons.
- a. We believe that winterkill of winter grains planted last fall was higher than normal. These grains generally account for one third of Soviet grain harvests.
- b. Soil moisture conditions for spring grains, which will be planted this month, have been improving steadily, but are still not good following last year's drought.

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- E. In the area of consumer welfare, the Soviet populace this year faces the prospects of the smallest gains in the Brezhnev era.
1. The rate of increase in per capita real income will decline from the 1974-75 level, and the rise in the average wage for workers will be held below 3 percent. Both indicators reflect the limited prospects for increased supplies of consumer goods and services, as well as the leadership's determination to restrain inflationary pressure.
 2. Probably the most serious problem affecting the Soviet consumer this year is the anticipated one-fourth drop in per capita meat consumption. This will return the populace to the level of the late 1960s.
 - a. Despite gains during the past decade, the average Soviet citizen still eats only two fifths as much meat as his US counterpart and three fourths as much as the average Pole or Hungarian.

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b. As meat supplies are relatively abundant on the world market, we expect that the Soviets will import meat products this year. They could buy as much as a million tons -- their logistical limit -- which would raise per capita supply by about 10 percent; this would also add another 1 billion dollars to their already large import bill.

F. The 1976 plan calls for a rise of 13 1/2 percent in the value of foreign trade, a rate that probably will be exceeded by a wide margin based on past experience and the likelihood of continued inflation.

1. In their hard-currency trade, the Soviets probably will run a deficit on the order of 3-5 billion dollars.
2. The 1976 import picture is fairly clear. Imports from the West will continue to rise under the \$8 billion in contracts for plant, and equipment

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signed in 1974-75, and the grain bill will be at least 2 billion dollars.

3. On the export side, Soviet prospects depend primarily on the degree and pace of recovery in the West.
4. To finance the deficit, the Soviets will continue to resort to both credits and gold sales. As a result, they will end 1976 with an external debt substantially higher than at yearend 1975, but one that will still be within manageable limits.

The New Five-Year Plan

III. I will conclude this section, Mr. Chairman, with some comment on the Five-Year Plan for 1976-80, and then a few general observations.

- A. The USSR is starting the new plan period on an inauspicious note, with the consequences of the 1975 crop failure being felt strongly this year.
 1. The new plan presumably was in fairly firm shape, at least in its basic guidelines, before last year's drought

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occurred. Consequently, the planners must have had to do some serious re-drafting in the last half of 1975.

2. In the process they apparently opted for realism and moderation in setting goals. They seem to have largely avoided the taut and overambitious plans traditionally preferred by the Kremlin.
- B. The 1976-80 targets imply a GNP growth of 5 percent on an average annual basis -- somewhat lower than what was actually achieved in the 1960s. It is also lower than it first appears because it is calculated against a somewhat depressed 1975 base.
- C. In brief, the guidelines are as follows:
1. Agriculture will continue to receive an unusually large share of the country's total investment despite -- or perhaps because of -- this sector's disappointing development record;
 2. Growth in industry and construction is to feature gains in productivity and improvement in quality rather than brute force increases obtained through greater inputs of labor and capital. As you know,

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Mr. Chairman, this is a very old, almost wistful, theme in Soviet economic planning;

3. Under the plan the consumer is to hold his own compared with other resource claimants;
 4. We believe that long-term growth in military spending will continue for the next few years, albeit perhaps at a more moderate pace. I will treat this special subject a bit later.
 5. Trade with the West will increase in volume and in overall importance to the economy; this trade continues to play an essential role in Soviet modernization efforts.
- D. Let us look at industrial plans first. Industry is expected to continue its same steady rate of expansion as in the 1960s, at an average annual rate of 6 1/2 percent. The Soviets place even greater emphasis on higher quality of output and on the increased application of advanced technology.

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1. Machinery output -- the source of equipment investment, military hardware, and consumer durables -- is slated to grow at 9.2 percent annually, well above the 8 percent rate achieved during the first half of the decade.
 2. This high projection reflects the intention to raise the share of investment funds spent on equipment rather than on the construction of new facilities.
- E. Agricultural growth is to be substantially higher than normally scheduled -- an average of 5 1/2 percent, but this is against the low 1975 base.
1. The increase depends heavily on achievement of the grain harvest target of 215-220 million tons per year for the next five years. Except in 1973, when the harvest reached a record 222.5 million tons, the Soviet grain crop has always fallen well below this range.
 2. Apparently the leadership believes the 1975 downturn was an aberration unlikely

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to be repeated. In contrast, we conclude that the frequency of weather-related crop shortfalls foreshadows unfavorable conditions in at least one -- and perhaps two -- years out of the next five.

F. The rate set for new investment is unusually low: As a result, the Soviets will be hard-pressed to maintain the traditional high rates of increase in their stock of new plant and equipment.

1. The most striking change is the slow growth projected for capital investment -- 4 percent, or only three fifths of the growth actually achieved during the three preceding five-year plan periods.

a. The planners hope this reduction will force managers to use capital more judiciously -- by completing unfinished projects faster and by using of more technologically advanced machinery and equipment.

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- b. We are skeptical. The Soviets have been down this road before. While they have made some short-term gains, before long their planning and management system tends to undercut these initiatives.
- G. As for the consumer, he can expect a moderate, if slower, increase in his living standards. The regime has told the populace that its interests will not be sacrificed unduly to achieve other economic goals.
- H. In the area of foreign trade, the 5 to 6 percent average growth rate planned for 1976-80 is probably conservative, inasmuch as actual trade has usually exceeded original targets.
 - 1. Eastern Europe will remain the USSR's major trading partner, but the developed West have a somewhat larger share of total Soviet trade.
 - a. In buying from the West, the Soviets plan to concentrate on advanced equipment and technology; exports

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to the West will again feature fuels and industrial raw materials.

- b. Despite the recent rapid rise in Soviet hard-currency indebtedness, we expect the USSR to continue the extensive use of Western credits in 1976-80.
- c. The Soviet Union should be able to turn over its hard-currency obligations without any real problems, assuming (1) that Western governments remain willing to keep lending to Moscow and (2) there are no unusually severe or consecutive agricultural reverses.

Prospects

IV. In the past we have characterized the Soviet economy as having great crude strength. Growth has come more from the expansion of the number of units of labor and capital than from increases in the quality and efficiency of labor and capital.

- A. The Soviet leadership has insisted upon a rapid rise in expenditure on new plant and equipment and has extracted as large a work

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force as possible out of the populace. These have been hard-core economic policies.

- B. At the same time, the leadership has failed to close the productivity gap with the developed West. Measured in output per unit of capital and labor, productivity is only about one half that of the US.
- C. Given this mixture of achievements and shortcomings in mobilizing resources, the Soviet economy has demonstrated sufficient strength to do three things: (a) provide adequate support for an aggressive foreign policy and a formidable military posture, (b) slowly narrow the production gap with the US, and (c) gradually raise the level of consumption of the Soviet people.
- D. There are telling indications, however, that the Soviet economy will develop less rapidly than in the past.
 - 1. The current slowdown in the flow of new investment will force the USSR to operate an industrial plant that is growing older and more obsolescent.
 - 2. Annual increments to the labor force are

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scheduled to slow markedly by the early 1980s.

3. We doubt that the Soviet leaders will benefit as much from the application of new technology as they obviously desire.

Party thinking opposes radical reform of the economic system involving decentralization of decision-making and the introduction of effective financial incentives.

- E. Intimately related to the outlook, of course, is the share of Soviet resources allocated to defense -- a subject I am about to discuss. Let me note now only that if the Kremlin continues to allocate as great a share of GNP to defense programs as it does now, it will be hard pressed to sustain the 4-1/2 percent average GNP growth rate achieved over the past decade.

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PART II: SOVIET DEFENSE COSTS

I. Mr. Chairman, I will now turn to the allocation of resources to military and space functions in the Soviet Union. As you know, we completed our latest estimate of the dollar costs of reproducing Soviet military programs in the US in February. We have also published, in the last week, a major revision of our estimate of Soviet ruble spending for defense.

New Information

A. Before I review these estimates with you, I'd like to put them in context by discussing the new information and analysis which underlies the revisions. Some of our new data result from normal, annual revisions in our estimates of the size and characteristics of Soviet forces -- the building blocks which we use to construct our dollar and ruble estimates.

1. For example, as a result of the latest round of National Intelligence Estimates the intelligence community has revised its figures on the production rate of the Backfire bomber and of some major

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ground force weapons such as the T-72 tank and the BMP infantry combat vehicle. We also revised our estimates of the deployment rates of several strategic missiles and tactical aircraft.

2. In the spring of last year we completed a major interagency study of Soviet military manpower. That study resulted in an upward revision of the estimated level of active military manpower, and an offsetting decrease in estimated civilian manpower. We also made some changes in the distribution of manpower along the Soviet military services.
3. We also improved our knowledge of the technical characteristics of Soviet weapons.



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- B. As part of our continuing effort to improve our costing techniques, we conducted an extensive survey aimed at identifying aspects of Soviet military programs which were not explicitly

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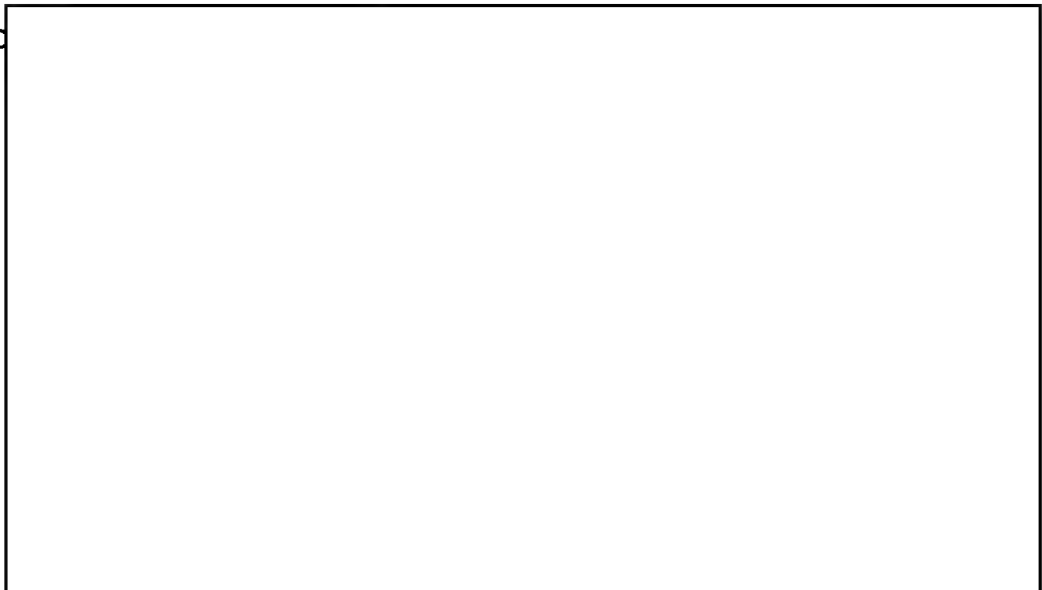
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accounted for in our previous estimates.

1. This year, we have included, for the first time, explicit estimates for Soviet preinduction military training and utilities for military facilities.

C. We also made major improvements in the past year in our methodologies for estimating the dollar costs of Soviet weapon systems. Some of the top weapons experts in the US military and in industry helped us.

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Impact of Changes on Dollar Cost Estimates

II. To illustrate the impact of these changes, let me now discuss our latest estimates of what it would cost in dollars to reproduce Soviet military programs in the US.

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- A. Our current estimate -- shown on this chart -- is that the dollar cost of Soviet military programs for 1975 is 114 billion dollars, expressed in constant 1974 prices. (*Chart: US Expenditures and Estimated Dollar Costs of Soviet Defense Programs*) That total exceeds comparable US authorizations for 1975 by about 40 percent.
1. If the costs of pensions are subtracted from both sides, Soviet programs in 1975 exceed US authorizations by some 50 percent.
- B. The last published CIA estimate, disseminated in January 1975, showed the total dollar costs of Soviet defense programs exceeding US authorizations by 20 percent in 1974.
- C. The estimates which I have been discussing with you today show the dollar costs of Soviet programs exceeding the US authorizations in 1974 by about 30 percent.
- D. This upward adjustment of about 10 percent was caused by two factors. The first was a downward revision in US authorizations in the latest Five Year Defense Program. But more important were the changes which I have just

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described in our estimates of the size and costs of Soviet programs.

1. The comparison between US and Soviet programs is particularly striking in the investment area, shown on this chart. (*Chart: Dollar Cost of Soviet Programs as a Percent of US Defense Expenditures -- Investment Cost*) In investment -- which includes procurement of weapons and equipment and construction of facilities -- estimated dollar costs for Soviet programs exceeded US spending by 85 percent in 1975.

E. I'd like to note that the comparisons I've just made represent nearly the limit of utility of our dollar cost estimates.

1. They can provide a general appreciation of the magnitude of Soviet defense activities in terms familiar to US decision makers. They can also reveal broad trends in relationships between the US and Soviet defense establishments that are difficult to measure in other ways.
2. While there is some relationship between dollar costs and military capabilities,

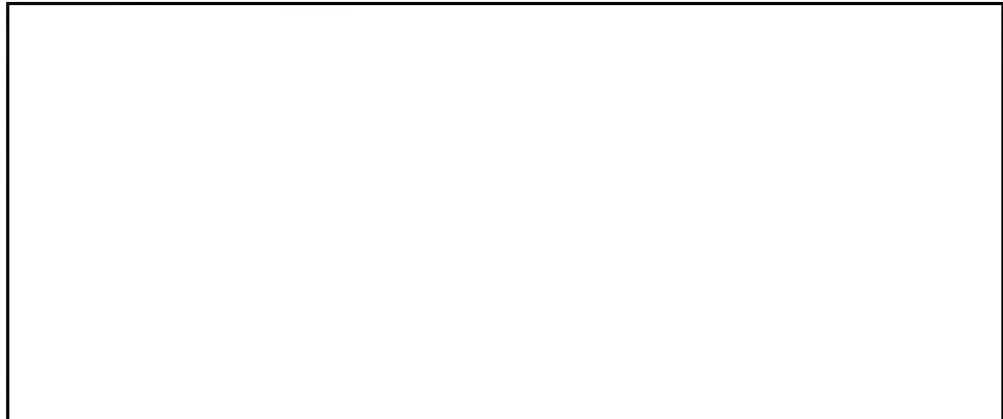
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the dollar cost estimates can not be used to draw inferences about relative military effectiveness. Other data, such as the composition of the forces, the characteristics of weapons, and the strategic environment in which they might be used, are far more important in making such judgments.

3. Moreover, we should bear in mind that the two powers have different military requirements. Our bombers, for example, impose a heavy need on the USSR for air defense; the reverse is not true.
4. Nor can these dollar numbers be used to draw conclusions about the burden of defense on the Soviet economy. For that purpose we estimate Soviet defense spending in rubles.

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Revision in Ruble Estimates

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A. Our ruble estimates -- like the dollar estimates I have just discussed -- are based primarily on a direct-costing methodology.

1. Both estimates begin with the detailed identification and listing of the physical components and activities which make up the Soviet defense program for a given year. The physical forces and programs which we cost in rubles are precisely the same as those which we cost in dollars. Consequently, changes in our appreciation of the Soviet force structure have an impact on both the ruble and dollar estimates.
2. To estimate some ruble expenditures, like personnel costs, we apply ruble costs directly. For other items, we convert the estimated dollar costs of Soviet equip-

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ment and activities to ruble terms. We do this by applying ruble-to-dollar conversion ratios for various classes of equipment and programs, reflecting our appreciation of the relation of Soviet to US prices in these areas.

- B. As a result of an intensive collection and analytical effort over the past several years, we have acquired a great deal of new information on the ruble prices of Soviet military equipment. This new data -- [REDACTED]

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[REDACTED] - has changed markedly our appreciation of the ruble costs of Soviet military programs, particularly in high technology areas. This resulted in major adjustments in many of the ratios used for conversion from dollar to ruble terms.

1. [REDACTED]

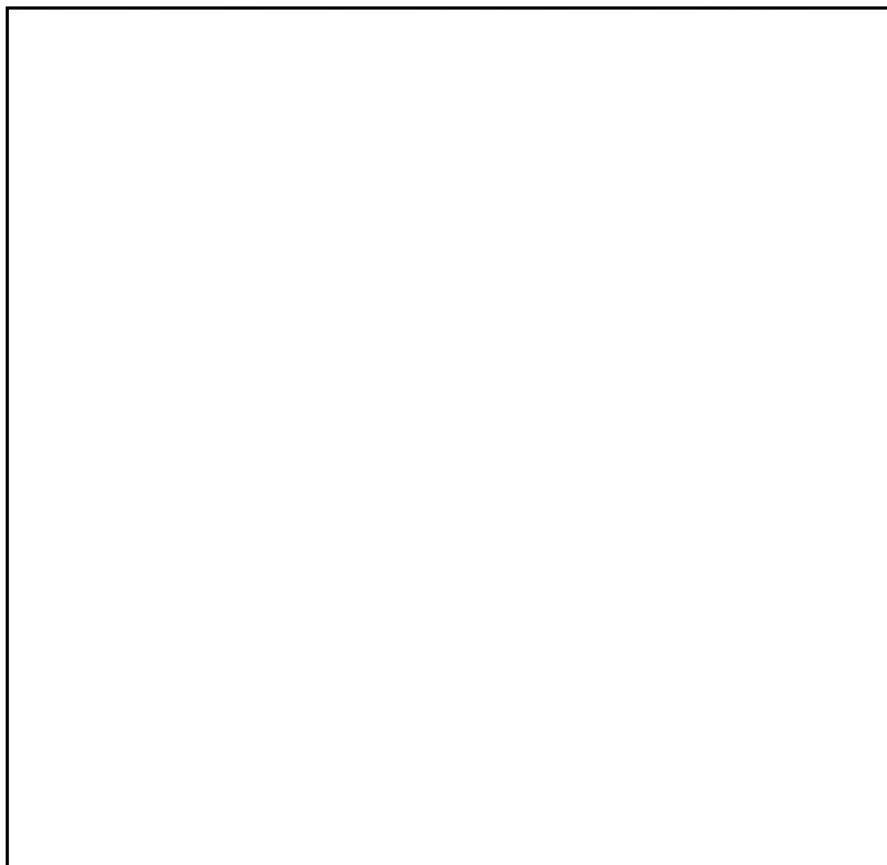
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2. We have also acquired a number of ruble prices for Soviet aircraft and their components, as well as for missile components and electronics. Analysis of this information indicated that in these areas -- as in shipbuilding -- major upward adjustments were required in our ruble-to-dollar conversion ratios.
- C. The effect of the changes I have described so far is illustrated on this chart, which shows our latest estimates of Soviet de-

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fense spending in rubles. (*Chart: Estimated Soviet Expenditures for Defense, 1970-75*)

1. In our estimates, we have postulated two possible definitions of defense activity, because we do not know precisely how the Soviets account for their defense programs. Using a definition which encompasses a range of activities comparable to those included in the US budgetary definition of defense, we estimate that the USSR spent some 40-45 billion rubles in 1970. In 1975 estimated total outlays for these purposes had risen to 50-55 billion rubles, measured in constant 1970 rubles. This is shown by the lower band on this chart.

a. Under a broader definition -- one which the Soviets might use and which would include additional military-operated programs such as the entire space program -- we estimate that total defense

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spending amounted to 45-50 billion rubles in 1970 and rose to 55-60 billion rubles in 1975. This definition is portrayed by the upper band. The single line below shows the announced Soviet defense budget.

2. The new estimates for 1975 are about twice the previous intelligence estimate of defense spending in that year. About 90 percent of the increase in the estimate is accounted for by our new understanding of Soviet prices and costs.
3. Our new estimates indicate that the average rate of growth in ruble expenditures for defense during 1970-75 was 4-5 percent. The annual growth rates varied during the period, however, as shown on the lower part of the chart, reflecting primarily the contraction and expansion of procurement outlays for strategic missiles. Historically, the growth in total Soviet defense spending has accelerated during periods when the USSR re-equips its forces

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with new strategic weapons. As these programs reach completion, the rate of growth in overall spending tends to decline.

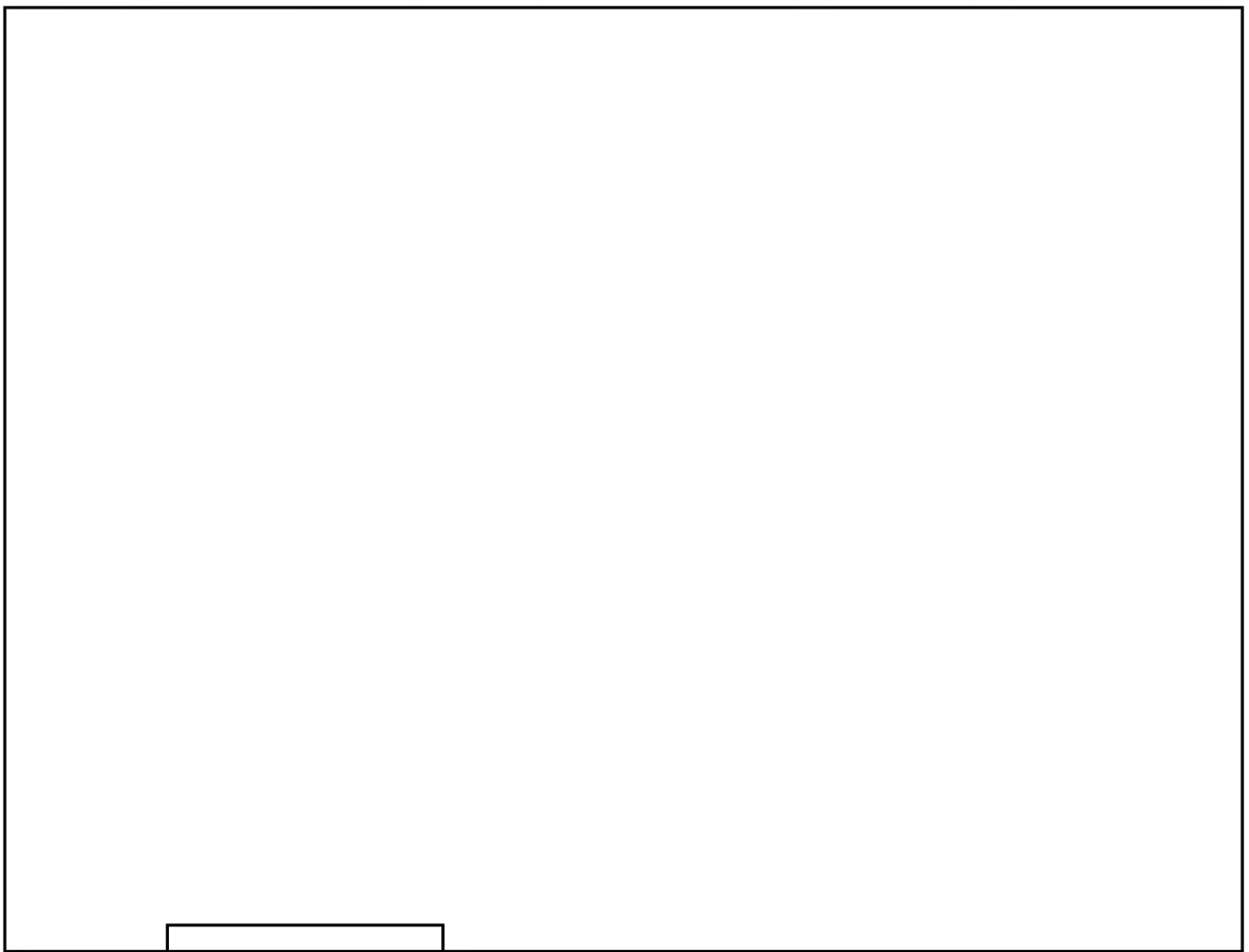
4. Previous estimates, while showing the same general pattern of growth, placed the long-run average annual rate of growth of Soviet defense expenditures in rubles at about 3 percent. The new ruble prices of military hardware indicate that high-technology programs -- the most rapidly growing component of Soviet military expenditures -- are much more costly to the Soviets than we previously believed. As a result, the new estimates show more rapid growth.
5. This chart shows how our new estimates of ruble prices for Soviet equipment have affected the growth rates. (*Chart: Estimated Soviet Defense Investment Expenditures, 1970-75*) Investment -- procurement of weapons and equipment and construction of facilities -- comprises about 40 percent of total Soviet

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defense spending in rubles. This growth reflects both the emphasis the Soviets are putting on modernizing their forces with new, high technology systems and the fact that these items are extremely costly to them.

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I want to emphasize, however, that

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much of the new data underlying the revision is still being evaluated. Consequently, the estimates should be considered as interim, and subject to change as the work progresses and new information is acquired.

- C. The methodology we use contains inherent limitations and while the new data do improve our confidence in the present results, they must be treated with reserve.

Resource Implications

- V. To close this portion of the briefing, I'd like to discuss the resource implications of our new ruble estimates. Although no single measure adequately describes the economic impact of the Soviet defense effort, defense spending as a share of gross national product is often used for this purpose.
- A. When measured according to a definition of defense activities roughly comparable to that used in the US, the Soviet defense effort absorbs some 11-12 percent of Soviet GNP. When the calculation is based on the broader definition of defense, the share increases to about

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12-13 percent. Because the rate of growth in defense spending was roughly the same as the growth in GNP during 1970-75, there was little change over the period in the share taken by defense.

1. The new estimate of the share of defense in the Soviet GNP is almost twice as high as the 6-8 percent previously estimated. As Mr. Bush stated earlier, this does not mean that the impact of defense programs on the Soviet economy has increased. -- only that our appreciation of this impact has changed. It also implies that Soviet defense industries are far less efficient than we formerly believed.
- B. Another economic aggregate which may be used to describe the impact of defense programs on the economy as a whole is the defense share of machinery output. At present Soviet defense takes about one third of the output of the machine-building and metal-working sector -- the sector that produces investment goods as well as military weapons and equipment.

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C. We do not know exactly how the Soviet leaders evaluate the size and economic burden of defense. Some leaders often make public statements which reflect their concern about the sacrifices in economic growth and consumer satisfaction that follow from their defense priorities. This concern, however, has not prevented steady increases in military programs. Major defense programs have been generously supported even in periods of economic setbacks.

1. Of course this situation may not always obtain, and the problem of lagging economic growth will make steadily rising defense costs a painful issue for the leadership.

a. But the economic burden will not be the only, or perhaps even the major, consideration in its specific decisions on future defense programs.

b. Other factors -- such as the leaders' views of foreign military threats, the powerful institutional forces which support defense programs, progress in arms limitations negotiations, and the

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momentum of technological advances in the defense sector -- will also have a major impact.

2. While the implications for future programs of our new perception of the Soviet defense effort are not yet clear, we believe that long-term growth in military spending will continue, albeit perhaps at a more moderate pace for the next few years. The annual increment in Soviet GNP is large enough to allow both increases in defense spending and at least slow improvements in living standards. Moreover, even the present level of Soviet defense investment programs is so high that with modest rates of growth -- or even with a constant level of defense spending -- inventories of military equipment could continue to rise. Much work remains to be done, however, in assessing the implications of our new estimates of ruble defense expenditures for future Soviet policy decisions.

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VI. Mr. Chairman, we have more detailed data on the allocation of our estimates to military mission or resource categories. Rather than go into them here, I will make this information available to your committee as part of the sanitized version of our testimony, and proceed now to the question of China.

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PART III: THE CHINESE ECONOMY

Data Availability

I. In turning to China, Mr. Chairman, let me stress one basic analytical problem: very little hard economic information is available on China, compared with the large amounts concerning the USSR.

A. Nevertheless, we do have enough data 25X1
 to establish the outlines of economic policy; to analyze foreign trade in some detail; and to ascertain general trends in domestic output, weapons development, construction, and consumer welfare.

Development Objectives

II. In its planning, Peking has two fundamental economic objectives: first, to maintain an adequate level of food and clothing for the growing population; and second, to develop a modern industrial base that, while small, will be capable of supporting a strong defense force.

A. In pursuit of these objectives, China initially adopted the Soviet model for both its economic organization and its pattern of resource allocation.

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- B. Soon, however, it became apparent that Soviet-style policies and institutions were in many ways inappropriate.
- C. In the first major reform, you may recall that in 1957 Peking tried to increase efficiency by revamping its highly centralized planning and management procedures to allow for greater participation by the provinces and lower levels.
- D. The second major change was begun in the early 1960s, following a series of crop failures. China was forced to increase the share of resources going to agriculture.
 - 1. With land limited, expansion of production had to come from increased yields. This in turn required costly modern inputs such as chemical fertilizers.
 - 2. The priority accorded agriculture showed most recently in 1972-73 when the Chinese decided to make large-scale purchases of Western plants and equipment to produce chemical fertilizer and synthetic fibers.
- E. Next in investment priority, following agriculture and those industries directly supporting agriculture, are certain segments of industry, the

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military establishment, and transportation and communications.

1. In industry, the favored positions of the petroleum and petrochemical industries are clear. An investment shift benefiting coal and iron ore mining, and especially finishing facilities for steel products, has also been taking place.
2. In transportation, large investments have been made at China's major seaports to handle the recent sizable expansion in foreign trade.

Consumption Trends

III. What, you may ask, has been the result of these shifts on the Chinese people?

- A. Probably most important is the fact that per capita real consumption has gradually risen, even though the share of national output going for consumption has steadily declined. This rise in consumption has appeared largely first in industrial consumer goods and second in services provided by the state, particularly health and education.
 1. Consumption has grown most rapidly in rural areas. They have benefited from government policy to encourage production and to narrow

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the gap between income in the countryside and the cities.

2. The slower rate of urban consumption growth has caused some labor problems in recent years. Average wages are now only slightly above the level of the late 1950s.

B. Widespread dissatisfaction with wages became apparent during the 1974 campaign to criticize Lin Piao and Confucius.

1. Despite a highly-charged political atmosphere, which made it risky to complain about personal welfare, workers persisted in voicing their grievances.
2. While officials have hinted that the problem will be dealt with in the future, it will not be readily solved because it involves political issues of ideological versus material motivation -- plus the practical problems of allocating scarce resources.

Economic Growth Since 1965

IV. I will now turn to the trend of Chinese economic growth over the past ten years. (*Chart: China: GNP, Industrial Production, and Agricultural Production*)

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- A. As this chart shows, the rise has been impressive, but erratic. Domestic political upheavals largely explain the uneven pattern.
 - 1. As you see, production fell sharply in the aftermath of the Great Leap Forward (1958-60) and to a lesser extent during the Cultural Revolution (1966-69).
 - 2. The anti-Confucius campaign in 1974 -- although less disruptive -- took its toll slowing the expansion of output.
- B. Nevertheless, with the help of a large investment program, China's gross national product in 1975 was roughly 75 percent larger than it was in 1965.

Industry

- V. China's industrial production grew at an even faster pace. In 1975 it was almost two and a half times the level of 1965 -- an average annual growth rate of 9 percent. (*Chart: China and USSR: Industrial Production*)
 - A. You can see that Chinese industrial growth compares favorably with that of the USSR, even though the pattern has been much less steady.
 - B. As would be expected in an economy stressing investment, output of producer goods has grown

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more rapidly than has production of consumer items -- averaging 10.5 percent a year.

1. Machinery production, a major component of producer goods, has grown even more rapidly -- by 14 percent yearly.
2. Progress in the petroleum industry has been particularly noteworthy. In the past decade, crude oil production has grown seven-fold, from 220,000 barrels a day to 1.6 million barrels a day.
3. But even in those sectors where growth has been less spectacular, substantial progress has been made: in steel, a troubled industry in recent years, output during the past decade has more than doubled.

D. In comparison, the growth of industrial consumer goods production has averaged 7 percent yearly since 1965.

1. Some items, made entirely from industrial raw materials, have grown more rapidly; for example, the output of bicycles has risen by 13 percent yearly.
2. Other items, which depend on raw materials from agriculture, are relatively sluggish;

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for example, cotton cloth production has grown by only 2 percent yearly.

- E. Since most consumer goods in China are derived either directly or indirectly from agriculture, the practical necessity for heavy investment in agriculture becomes more apparent from the above data.
- F. Before turning to agriculture, I would make a few comments on industry's figures for 1975, when production rose by about 10 percent, up from only 5 percent in 1974.
1. First, the factors that lowered performance in 1974 -- coal shortages, work stoppages, and transport tie-ups -- were less prominent in 1975.
 2. These depressing factors still had their affect, however. For example, steel production, which grew by 9 percent in 1975, was nevertheless only 2 percent higher than in 1973.
 3. In contrast, the petroleum industry continued its strong growth, with a 20 percent increase.
 4. Healthy gains were reported for other commodities, but in many instances these gains largely represented a step-up from the lackluster performance of 1974.

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Agriculture

VI. Now, a few points on China's agricultural picture.

- A. First of all, foodgrain production in the past decade has barely kept pace with the estimated 2 percent annual growth in population. And, cotton output has not even met this low rate of growth -- growing by only 16 percent over the entire ten-year period.
- B. This may be a good place to draw attention to Peking's recent successes in population control.
 - 1. New research indicates that annual population growth has fallen appreciably since 1970, perhaps from 2.3 percent in 1970 to 1.8 percent in 1975. A continuation of present policies should lead to even further drops in the birth rate.
 - 2. These gains reflect Peking's sober appraisal of the difficulties inherent in raising agricultural output.
- C. To return to agriculture, it is interesting to note that year-to-year fluctuations in Chinese output of grain have historically

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been much narrower than fluctuations in Soviet output, as this chart shows. (*Chart: China and USSR: Grain Output*)

1. Over the past five years, for example, Soviet grain output has fluctuated by as much as 27 percent from expected output, compared with a maximum deviation of about 2.5 percent for China.
 2. The primary reasons are differences in cropping practices and weather patterns.
 - a. China practices multiple cropping, and weather patterns rarely produce a poor harvest in both North and South China in the same year.
 - b. In contrast, the Soviet Union produces more than two thirds of its grain in regions of marginal precipitation, frequently subject to drought.
- D. In 1975, Chinese agricultural production showed no appreciable improvement over 1974.
1. Foodgrain production was essentially unchanged from the record crop of about 260 million tons (excluding soybeans) in 1974.

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2. Soybeans and some minor industrial crops gained slightly; cotton output may have declined by as much as 10 percent.
3. Improved harvests in regions surrounding North China's major cities permitted a reduction in grain imports in 1975 to only 3.3 million tons, about one half the 1974 level. Shipments were almost entirely under long-term agreements with Canada and Australia.
4. China re-entered the world cotton market last fall and had purchased 70,000 tons by the end of the year.

Foreign Trade

VII. I will now turn to China's foreign trade. China's total trade was \$14 billion in both 1974 and 1975, as shown in this chart. (*Chart: China: Foreign Trade, by Major Area*)

A. Taking a longer view, the value of China's foreign trade in 1975 was more than three and a half times trade in 1965, although the growth shown for recent years is exaggerated greatly by price increases.

1. The past decade also saw a further shift in China's trade orientation toward the Developed West and away from the USSR.

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Whereas two thirds of trade was with Communist nations in the late 1950s, the share now is less than 20 percent.

B. The jump in imports in recent years in part reflects Chinese willingness to incur debt in order to purchase Western industrial plants and transport equipment in quantity, as shown in this chart by the trade deficits since 1973. (*Chart: China: Trends in Foreign Trade*)

1. In 1974, the Western recession depressed demand for Chinese exports and contributed to a record trade deficit of \$800 million.
2. In 1975, by trimming imports and pushing exports, the deficit was reduced to less than \$400 million.

C. Imports of machinery and equipment continued to climb in 1975, reaching \$2 billion, compared with \$1.6 billion in 1974 and \$330 million back in 1965.

D. By contrast, China cut back sharply last year in agricultural imports.

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1. At \$820 million, they were less than half the 1974 figure and not much greater than the \$710 million of the years earlier.
- E. China's emergence in 1973 as an oil exporter came at an opportune time.
1. Earnings from expanding oil exports have compensated for falling demand in the West for Chinese textiles and a variety of light manufactures and handicrafts.
 2. Oil exports of 172,000 barrels a day to non-Communist countries earned \$750 million in 1975, up from 88,000 barrels a day and \$450 million in 1974.
- F. During 1975 a pause took place in new purchases of whole plants from the West in order to absorb the industrial plants already ordered.
1. During 1972-74, China signed contracts for about 110 plants, worth \$2.2 billion, for delivery through 1978.

Trade With the United States

VIII. As for United States - China trade, the surplus of almost \$700 million enjoyed by the US in 1974 fell to less than \$150 million in 1975.

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- A. Agricultural exports, which accounted for 80 percent of total US exports to China in 1972-74, have been phased out for the time being.
- B. US exports to China in 1976 may be less than the \$300 million of 1975.
 - 1. In contrast to farm products, however, US industrial exports should continue strong on the basis of previous contracts for plants and equipment.
- C. This year, US imports from China may rise to \$200 million from the \$160 million of last year.

Foreign Economic Aid

- IX. One other element worth noting is China's foreign economic assistance program. (*Map-chart: China: Aid Activities, 1956-75*) During the past two decades, Peking has pledged \$4 billion in economic aid to the LDCs, about two-thirds of the total going to Africa. This aid is provided through interest-free credits with extended repayment schedules.
 - A. About \$1.7 billion of this aid has already been drawn.
 - B. The single most important project has been the recently completed \$400 million Tan-Zam

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Railroad, which links the Zambian copper belt to the Tanzanian port of Dar es Salaam.

- C. In 1975 the general pattern continued. Peking signed agreements for new aid totaling about \$300 million, of which \$180 million was with African countries.

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PART IV: THE COSTS OF CHINESE DEFENSE PROGRAMS

I. In this last section of my prepared statement, Mr. Chairman, I will comment on the costs of China's defense programs. The basic consideration to bear in mind is that the Chinese military in many ways mirrors the economy that supports it.

A. For its combat strength, the greater part of China's armed forces relies upon manpower and easily manufactured, low-technology weaponry. This like most of China's economy is labor intensive, with little capital.

B. In contrast, China has also developed and deployed a limited number of modern weapons, reflecting the mastery of some of the technology of an advanced industrial nation by the economy's small, capital-intensive sector.

C.



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defense production accounts for a large portion of activity in the advanced industrial sector -- far larger, for example, than is the case in the US or USSR.

D. Some understanding of trends in China's defense effort can be obtained by examining our esti-

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mates of dollar costs for procurement of military equipment.

1. The term "procurement" as we use it here includes only the cost of producing arms and equipment, not any costs associated with research, development, testing, and evaluation (RDT&E), or those for facilities, personnel or operations and maintenance.
2. Let me remind you that dollar cost estimates reflect the cost of reproducing the Chinese programs in the US.

II. Chinese military procurement, as measured in constant 1974 dollars, grew very rapidly in the late 1960s, but after 1971 fell substantially. For the next three years it remained at a plateau about equal to the 1969 level as shown in this chart. (*Chart: China: Military Procurement*)

- A. Much of the decline resulted from a sharp drop in aircraft production, but there was some slow-down in almost all of the Chinese weapon procurement programs. (Preliminary rough estimates show a somewhat similar trend in RDT&E costs, with rapid growth in the late sixties, a peak in the 1970-71 period, and a subsequent decline.)

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B. As you can also see in the chart, there was a distinct rise in estimated procurement costs in 1975, although the level is still much below the 1971 peak.

1. Most of this increase is attributable to more costly aircraft and to some increase in ship production.

C. What meaning do we attach to the lower level of procurement since 1971?

1. It does not involve a reduction in Chinese forces, but rather shows that new equipment is being delivered to the forces at a slower rate.

2. The primary reasons for this decline probably are:

-- a reduced likelihood of armed conflict with the Soviet Union;

-- new priorities favoring civilian economic growth by a less military-oriented leadership; and

-- difficulty in developing follow-on advanced weapon systems.

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III. China's past history of sudden bursts and unexpected reductions in defense production makes it difficult to judge whether the upturn in 1975 is a temporary phenomenon, or the beginning of a long-term trend.

I offer a couple of projections, however.

A. First, over the next several years, as the Chinese begin to replace obsolescent equipment with more modern systems, procurement costs can be expected to grow somewhat, even if production in terms of numbers of units does not increase.

1. In 1975, for example, the increased production costs of a few relatively more modern and expensive weapon systems more than offset savings from the reduced production of older and cheaper weaponry.

B. Second, the present general ordering of military versus civilian priorities probably will persist through this decade, no matter who wins the current struggle for political power.

1. This is because the two most important bases of this ordering will continue to be the controlling factors for the remainder of this decade. I refer to the cost and difficulty

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of a more ambitious weapons effort, and the urgency of China's need to modernize and expand its basic agricultural and industrial production capacity.

C. Third and last, this does not preclude further military growth and modernization.

1. If economic factors dominate defense policy decisions, the growth and modernization can be expected to proceed at a measured pace that will probably increase gradually as China's industrial base expands.
2. A sudden diversion of resources into defense production, however, can not be ruled out if Chinese policymakers were to perceive a substantially greater external threat. As you know, China's perception of an increased threat from the USSR in the late sixties led to the rapid expansion in defense programs at that time.
3. Moreover, China's now enlarged military industrial base, resulting from that buildup, provides China with the potential for a much greater military production effort.

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